From shareholder value to private equity – the changing face of financialisation of the economy[i]

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Summary

Across the OECD, a process of financialisation of the economy can be observed. Defined as the increasing dominance of the finance industry over the real economy and workers, financialisation can take different forms, including: growing instability and opacity of financial markets, increasing focus on shareholder value and the rise of alternative investors. This article reviews in particular the challenges to trade unions posed by the rise of the shareholder value model of governance in listed companies – as seen during the review of the OECD Corporate Governance Principles in 2004 – and more recently the boom in private equity buyout transactions. The trade union response to financialisation has followed two tracks: (i) to engage in regulatory advocacy at national and international levels for stakeholder approaches to corporate governance and financial markets and (ii) to mobilise workers' capital managed by pension funds to ensure responsible and long-term investor behaviour.

Keywords: corporate governance, workers' capital, worker participation, private equity, OECD, financialisation, financial markets

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'Financialisation: the increasing dominance of the finance industry in the sum total of economic activity, of financial controllers in the management of corporations, of financial assets among total assets, of marketised securities and particularly equities among financial assets, of the stock market as a market for corporate control in determining corporate strategies, and of fluctuations in the stock market as a determinant of business cycles'. Ronald Dore, former OECD consultant and Professor at the London School of Economics and Political Science. (Dore 2002)

The process of financialisation of the economy

Workers have not participated equitably in the benefits of the current wave of globalisation. Across the OECD the share of wages in national income has been decreasing in the past decade, while benefits of economic growth have accrued disproportionately to the wealthiest families. The growing inequalities within industrialised countries have led to the appearance of the 'working poor' – something which ought to be a contradiction in terms – at one end of the scale and of the 'hyper-rich' – whose annual revenues amount to dozens of millions of euros – at the other end. Inequalities and absence of redistribution of the massive wealth creation exist in a context of prolonged deflationary pressures on wages worldwide and, by opposition, an uncontrolled speculative rise in financial and property prices. This decoupling of the returns to labour and capital reflects in part the increasing financialisation of the global economy: a process by which financial markets value and activities have priority over the real economy and the production of goods and services that create wealth to satisfy the needs of societies. According to the OECD, a well-functioning financial system should 'permit the economy to fully exploit its growth potential by ensuring that investment opportunities receive necessary funding at minimum costs' (OECD 2007a). Today we are far away from achieving this goal.

Financialisation appears as the cause of increased, not less, market instability. Reforms have deregulated the investment chains between the ultimate owners of capital (including working families and retirees' pension funds) and the final destination of their investment (including in listed and unlisted companies). When coupled with market liberalisation, this process of deregulation has allowed financial operators to innovate in providing products and services that are increasingly opaque. Not only are 'real' assets invested and traded (debt and equity) but so are credit default risks (credit derivative products). However – and until the recent subprime financial crisis – 'financial innovation' was portrayed by international organisations as a welcome development in so far as it contributed to spreading credit default risks among a broader, if not infinite, pool of investors. Assuming that the risks were well understood by market participants, such spreading would mitigate the systemic impact of any large-scale credit events. Derivative products such as collateralised debt obligations – we were told – contributed to more, not less stability on financial markets. However financial innovation also came at the cost of a gradual erosion since the Asian financial crisis in 1997 of the powers of regulatory authorities and central banks in monitoring financial markets and in anticipating the creation of speculative bubbles.

The financial shock created by the subprime mortgage crisis in the United States is a tragedy for many of the lower income families involved who lost their housing. Its transformation into global financial turmoil during the summer and autumn of 2007 has further shown the

dangers of excessive financial innovation. The growth of derivative products has resulted in the US residential mortgage debt default being passed on to global credit markets and has served to accelerate the crisis. Contagion was fuelled by the opacity of derivatives' asset price fixing and underlying risks, the highly leveraged investment strategies of hedge funds, the widespread use by banks of off-balance sheet and unregulated 'special investment vehicles', and the absence of adequate public regulation and supervision. Prior to the crisis, trade unions raised concerns at the security of investments by union pension funds in what we feared would turn into an investment bubble, should the economic climate of low interest rates, available liquidity and rising stock markets change. Regrettably the subprime crisis showed how right that warning was.

The review of the OECD Principles of Corporate Governance in 2004

At company level, the process of financialisation is linked with the shareholder value model of governance of firms, which gained momentum in the US and the UK in the 1990s and became the predominant model for reform promoted by international organisations such as the OECD and the World Bank. The shareholder value model – by opposition to the stakeholder approach – encourages financialisation of the company since it contends that the maximisation of the value of shares rather than long-term profits is the central purpose of a firm. By focusing on a short-term shareholders' financial interest, corporate management can tone down, or even disregard altogether, the claims of other parties including workers. They can also have part of such claims externalised to society. In the name of shareholder value, corporate management can decide against investing in the company's productive assets, and prefer dividends and other financial transfers made in the interests of shareholders. During the late 1980s, the fundamental shift in strategy observed throughout major US multinational enterprises has shown the negative impact on investment in human capital and research and development. More recently the shareholder value model has been portrayed as a cause for short-termist behaviour by British listed companies (TUC 2006).

In the major OECD economies the growth of dividends paid to shareholders has outpaced the growth of corporate profits. Between 2001 and 2005 marginal payouts – defined as the change in dividends divided by the change in profits – grew by 51% in the US, 92% in Italy, 88% in the Netherlands, and 78% in France – and was positive in all major OECD countries (OECD 2007b). In addition to dividends, shareholders receive additional remuneration via share buy-back programmes whereby a company buys its own equity in order artificially to inflate its market value thereby boosting senior management stock options and discouraging hostile takeover bids. Share buy-backs were a minor source of shareholder remuneration a decade ago but have now become widespread across the OECD. In 2004 in the US, US$224bn was spent on share buy-back programmes, coming on top of US$202bn distributed in dividends (Mauboussin 2006). The dominance of 'shareholder values' has also benefited those at the top of corporations. John Coffee, an economist from Columbia University in New York, has provided evidence on the negative consequences of massive growth in stock options during the IT market bubbles in the late 1990s (Coffee 2003). The ratio of US-based Chief Executive Officer (CEO) compensation to the average production worker compensation has jumped from 30 to 1 in 1970, to 500 to 1 today. Between 1993 and 2005 US public listed companies' executive compensation totalled over US$350 billion. The

aggregate compensation paid by US firms to their top five executives rose to over 10% of these firms aggregate net income for 2001-2003, up from under 5% during 1993-1995.

Unions represented at the OECD via the Trade Union Advisory Committee to the OECD (TUAC) have consistently rejected the shareholder value model as the model for the future. Our main line of argument has been to stress the firm-specific investment of the worker. Workers invest specifically in the company that employs them and are equally exposed to firm-specific risk. Indeed fixed contractual relationships between employees and the firm – be it the employment contract or the collective agreement – do not adequately protect workers' interests, nor are they incentives to maximise firm-specific investment in human capital or ensure workers' commitment to the company and its strategy. Accordingly, workers need to participate in the governance of the firm above and beyond the mere respect of the contractual terms that bind them with the company. Active participation can be supplemented by strong union presence in the company and active dialogue between unions and management. However, in many cases, effective participation is best served by legislation. Legislation on worker participation is most developed in civil law jurisdictions, notably in continental Europe, where workers' employment contracts and collective agreements are usually supplemented by institutional representation in the firm: elected employees sitting in works councils, occupational health and safety committees and board-level employee representatives (TUAC 2005).

Unions' opposition to the shareholder value model became apparent when the TUAC was invited to participate as an observer to the review of the OECD Principles of Corporate Governance in 2003. After extensive discussions among OECD member states during 2003, the final proposal for revision of the Principles presented in March 2004 was below unions' expectations. Immediately after its release to OECD member states, five global union leaders signed up to a joint call to extend negotiation to allow for a substantial revision of the Principles:

> *'The current OECD text fails to send a clear signal that the power of the imperial CEO will be curbed, that executive remuneration will be reined in, that company boards will be independent, diverse and accountable to all corporate constituents, including workers, that conflicts of interest among corporate gate-keepers and business service providers will be checked, and that institutional investors will be empowered to exercise their ownership responsibilities. Failure to act will amount to a missed opportunity that is most glaring in the case of the rights of employees and other stakeholders to participate in the corporate governance process.'*

Trade union mobilisation around the review was successful. Following a joint intervention by French unions, on 13 April 2004 the French government reversed its position and asked the OECD Secretariat to reopen negotiations on the 'Stakeholder' chapter of the Principles. Further to this, and parallel discussion with other continental European countries, the OECD Secretariat drafted new consensus language that redefined the rights of workers beyond those as 'established by law' to include 'mutual agreements' (deemed as collective agreements) and employee 'performance enhancing mechanisms' (OECD language for works councils, board representation, employee share ownership and profit sharing, occupational pension funds) as being 'permitted to develop' rather than simply 'permitted' (TUAC 2004)

Symbolic as these changes may appear, they are more than marginal. The added language has helped European trade unions to pursue with additional support the issue of worker

participation in corporate governance in various fora. Importantly, the OECD process has shown the ability of the labour movement through the TUAC, effectively to shape the outcome of an inter-governmental negotiating process – France reopening negotiations on the Stakeholder chapter – in the face of several hostile governments and a hostile business constituency. However the TUAC had to pay the price for that victory after the review. Although benefiting from an official advisory status at the OECD, the TUAC was excluded from the OECD Committee in charge of corporate governance and has not been reinvited since to interact directly with its members. This exclusion however has not diminished the TUAC's capacity to influence the work of the OECD on corporate governance. In May 2006, the TUAC was able to convince several member states, including Austria, Germany and France, to oppose a final draft OECD Methodology on the implementation of the Principles on the ground that it included a biased interpretation of the same worker-related text of the Principles that had been obtained at the end of the review in 2004.

The new challenges of financialisation: the case of private equity

The battle of ideas in the context of the financialisation of the economy is now taking on a new dimension with the emergence in the recent period of private equity. Historically, the concept of corporate governance has been built on the assumption that stock exchange listing would be the 'ultimate stage' of good governance. According to theory, stock listing provided for the best perspectives of corporate growth and wealth and required the most sophisticated mechanisms of accountability and reporting, given the number of corporate constituents. By contrast, unlisted company status was at best considered as a necessary – but, it was hoped – brief intermediary level before 'going public'; at worst, it was tolerated as a default option for countries – and mainly developing ones – lacking robust capital market infrastructure and regulation. This conventional wisdom has been challenged in recent years by the transformation of the private equity industry from a relatively marginal investment class to a credible alternative to stock exchange listing.

Trade unions have a clear interest in the long-term success of companies, as long as the wealth that is generated is shared equitably and workers get a fair share of that wealth. That is the social contract that binds workers to their company. Like under the shareholder value model for listed companies, this social contract is potentially at risk under private equity. The corporate governance and disclosure requirements that apply to private companies are considerably weaker than those for quoted companies in all OECD countries. More generally, private equity funds are exempt from many of the regulations that apply to traditional collective investment schemes, to banks and to insurance companies, notably in the areas of investment prudential rules and reporting requirements. These regulatory exemptions and gaps would need to be justified in the public debates. In particular the rapid transformation of the private equity investments from niche to mainstream businesses has not been matched by comparable changes in national regulations and international cooperation, and has left the real economy and its workers facing increasing pressure because of financial short-termism. Large regulatory gaps and loopholes have appeared and have been of benefit to the growth and success of investment managers.

That is not to say that all private equity firms and funds should systematically be considered as sources of danger for companies. In fact in North America and in parts of Europe unions

have had experience over a number of years of dealing with private equity investors at the venture capital end of the business as well as with some of the 'distress funds' specialising in turning round companies in difficulty. Venture capital has traditionally been seen as a non-controversial part of the financial architecture – where high returns to some investors have reflected the high risk of supporting start-up companies – and as a necessary contributor to overall growth. With regard to 'distress funds', unions, particularly in the United States, have on occasion adopted a proactive role in identifying investors and worked with them so as to restructure companies faced by severe problems and thus safeguard jobs.

Unions have concerns about the private equity business model based on high leverage and the pressures this puts on employment and working conditions as well as on tax revenues. Unregulated private equity investment may put the financial sustainability of the acquired company at risk. The ratio of debt to equity is typically 70/30 (or 230%) for companies under private equity regimes compared to 30/70 (or 43%) for public companies, and has increased in the recent years as deals have become bigger. Financial sustainability is at risk when the acquired firm is forced to contract 'dividend recapitalisations'. Recapitalisations consist in substituting new debt contracted by the target company for the acquiring private equity funds debt that was raised to finance the takeover of the company; the exchange happens by way of mega dividend proceeds. For example, the consortium of private equity firms that bought out Warner Music in 2004 had effectively repaid their entire investment less than a year after the purchase. A tightening of bank lending standards – as largely expected in the wake of the subprime crisis – will pressurise companies that were acquired during the boom time in 2003-2006 and have since been loaded with 'recapitalisation' debt. Before the outbreak of the crisis the British Financial Service Authorities warned against 'the possibility of jobs in "overleveraged" private equity companies starting to look increasingly precarious, and also identified potential risks to lenders and to financial stability if such lending turned out to be imprudent.' In July 2007, the rating agency Moody's voiced concerns about the growth of private equity buyouts and their excessive leverage and questioned the claims made by the private equity managers that private equity firms outperform their listed peers. In a report, the rating agency stated that the 'current environment does not suggest that private equity firms are investing over a longer-term horizon than do public companies despite not being driven by the pressure to publicly report quarterly earnings'. (Moodys 2007)

Studies, of which the most recent have been conducted in the UK, suggest that wages in private-equity-backed companies grow more slowly than in the private sector as a whole, and that the private equity management culture is not consistent with quality employment (Thornton 2007; Vitols, in this issue). We doubt whether the pressure for resale and capital gains over a relatively short time period are consistent with the need for long-term investment in areas such as skill development, research and development, product innovation and patent registration. There are also serious concerns with regard to the impact of private equity in sectors that ensure public service deliveries, and about corporate behaviour of listed non-private equity companies. The case of the nursing home industry in the US is emblematic in this regard. As revealed in a recent hearing at the US Congress, the leveraged buyout (LBO) financing requirements have pushed private equity-owned nursing companies to implement short-termist cost-cutting programmes which resulted in a fall in the quality of nursing care services in the US. Private equity-owned nursing companies influence the standards for the industry that have pushed non-private equity nursing companies to adopt similar short-termist management behaviour (Ways and Means 2007).

Workers' rights to consultation under private equity

Industrial relations are challenged under private equity. In those countries where private equity has become a significant owner of the private sector such as the UK and the US, unions have realised that under a private equity regime the management was no longer the prime decision-making body in the company. Private equity firms are able, via the ownership fund, to exert far more influence over the private company than in the case of shareholders with listed companies, but are not bound by regulation that applies to employers. The traditional model of trade union representation and collective bargaining does not work if the real decision makers are not present at negotiations. An example is the struggle of trade unions in 2004-2006 against the private equity owners of Gate Gourmet, a British airline catering service company with operations across Europe.

In the majority of OECD countries, workers are granted either through law or through collective agreement, rights to information, consultation and representation in corporate governance. Those rights are essential for workers and their unions when a company is taken over and to ensure continuity of their negotiated rights. These rights are most developed in Europe, thanks to the Acquired Rights Directive according to which workers' representatives are granted right to information and consultation on the proposed takeover, and the continuity of employment terms and conditions are guaranteed. The Directive further specifies that dismissals that would be directly linked to the transfer of ownership shall be considered as unfair labour practice. In the US, 'successorship clauses' in collective agreements also guarantee the continuity of the collective agreement after a takeover. However, in some cases the clauses require agreement between the union and the acquiring investors prior to the effective takeover. These 'ex-ante' rights have been very useful recently to facilitate 'worker-friendly' private equity investments in the steel industry (Wall Street Journal 2007). And when local unions are powerful enough to influence the takeover bid process, private equity takeovers can actually create opportunities for extensive unionisation of the target companies.

The protection of workers' rights has been challenged in recent years with the increase in private equity investment. In the case of Europe, the rights under the Acquired Rights Directive are activated only when there is an effective transfer of ownership of the company from one identified employer to another. However, the legal and financial mechanisms of LBO transactions do not necessarily involve a formal transfer of ownership: in essence LBO transactions are no more than share ownership and balance sheet restructuring. As noted in a report by Brian Bercusson, Kings College, for the ETUI-REHS:

> *'none of [the Acquired Rights Directive] protection is available in cases of takeovers by private equity. This is because the legal form of the takeover is a transfer of shares from the company's existing shareholders to the private equity firm. There is no change in the identity of the employer. As the employer remains the company (though with new, private equity shareholders) the [Acquired Rights] Directive does not apply.' (ETUI-REHS 2007)*

A four-pillar framework for private equity regulation

The trade union response to the challenges for workers posed by financialisation has followed two tracks: regulatory advocacy and mobilising workers' capital. The first track has involved advocating effective national regulation and developing international cooperation and coordination of regulation to restore balance between the real and financial economies. At the Heiligendamm Summit in 2007 Global Unions have called on the G8 to establish an international regulatory task force covering four areas (TUAC 2007a):

- Financial sustainability of the LBO financing: there needs to be a level playing field between alternative funds and other collective investment schemes with regard to transparency and reporting on performance, risk management and fee structure. The investment policies of private equity within the OECD zone should be regulated according to prudential rules aimed at both financial market stability and long-term asset value creation. Minimum funding rules are required.

- Workers' rights to collective bargaining, information, consultation and representation within the firm should be regarded as key mechanisms by which the long-term interests of private-equity-backed companies can be secured and promoted. In particular, workers and their representatives must have sufficient information on the strategy and the business plan that the private equity firm intends to impose on the management of the company.

- Tax regulation needs to be reconfigured to cover private equity regimes, so that tax systems are not biased toward short-term investor behaviour. Comprehensive answers should be developed so that the expanding activity of hedge and private equity funds does not jeopardise government revenues from corporate taxes.

- Corporate governance: current national corporate governance frameworks focus on publicly traded companies and have far weaker requirements for unlisted companies. The responsibility and powers of the boards of directors to preserve long-term interests of companies under a private equity regime or whose ownership structure includes hedge funds need to be reconsidered so as to improve responsible business conduct and prevent conflicts of interests.

Intensive trade union advocacy activities in 2007 have had an impact in the media and been reflected in parliamentary discussions in different countries. In November 2007, the TUAC conducted an overview of recent parliamentary hearings on private equity in 2007. The outcome of the review is synthesised in the table below. It shows a high degree of parliamentary activism across the OECD and that parliamentary discussions covered most, and in some cases all, of the above policy areas. It confirms that private equity is a cross-cutting issue and that it should be treated as such by governments.

Table 1: Overview of parliamentary hearings and legislative initiatives relating to the regulation of private equity between March and October 2007

Country	UK	Aus.	USA	D	DK	EU	NL
Labour and public interest							
Workers' rights to information and consultation during a takeover	**		*	**			**
Impact on employment and/or inequality of the private equity business model	*	*	*				
Impact of private equity investments in public services and/or strategic industries		*		***			
Financial sustainability							
Impact of the leveraged financing on the portfolio company	**	*	*	*			*
Spillover effects of the leveraged financing on listed companies	**	*					
Protection of the rights of creditors participating in leveraged financing	**	*	*			*	
Responsibility of institutional investors (including pension funds) investing in private equity funds	*		*				
Taxation							
Tax treatment of private equity managers' 'carried interest'	**	*	***	***			
Impact of leverage financing deductibility of debt on the portfolio corporate tax income base	**	**		*	***		
Tax regime of private equity firms			***	***			
Offshoring and overseas transactions	**	**	*		*	**	
Corporate governance							
Transparency of the unlisted private companies (compared to listed companies)	*	*					
Private equity firm's incentives to the board of directors to accept a takeover bid and other similar market integrity issues	**	*		***	***	**	***

* Addressed in public hearings or in the drafting of legislative proposals.
** Formal recommendations for government review / action.
*** Legislative reform proposal.
Source: TUAC 2007b.

Mobilising workers' capital

There is also a second track of developing the role of workers as investors. The scope for using our influence over workers' capital is closely related to the form of financing of the national pension system. However, using workers' capital as a tool is also crucial for the labour movement in a financialised economy. Workers' capital constitutes an important policy issue in countries where pension financing relies extensively on pre-funding (by opposition to pay-as-you-go redistribution), as is the case in Anglo-American common law jurisdictions. Workers' pension savings are invested in financial markets, including in equity, by their pension funds. In the US, the UK, Canada and Australia, workers' pension funds' holdings in equity amount to circa a fifth of those countries' stock-market capitalisation.

A proactive approach to managing workers' capital – sometimes known as capital stewardship – can help companies build long-term value while avoiding short-term excesses. The key idea is to influence corporate behaviour by using selective placing of worker capital through their shareholdings. A wide and varied 'toolbox' is available. Positive actions can range from coordinated shareholder activism and proxy voting campaigns to international engagement with companies in which retirement funds hold stock as well as investment managers. Alternatively, 'negative' screening is available to weed out companies pursuing undesirable practices (social, environmental, lacking workers' rights, etc) from pension fund and retirement investments. With effective organisation and coordination, worker capital can help to address persistent corporate failings, resulting in improved corporate governance. Capital can be steered to needy areas of the economy that traditional institutional investment has failed to serve properly, such as investing in projects that target job-creation, affordable housing, and small businesses.

In order to be successful, however, workers' capital requires effective coordinated action. A key challenge is helping workers' capital find its international voice, that is, developing a programme of trade union cooperation to implement effective workers' capital strategies globally. The ITUC, Global Union Federations, TUAC Committee for International Co-operation on Workers' Capital (CWC) was established in 1999 for this purpose, among others.[iv] CWC promotes international trade union cooperation on issues related to the investment of workers' capital. It is a trade union focal point for internationally coordinated shareholder activities and for exchanging views on topics ranging from corporate and financial market regulation and governance to trade union pension trustee education.

Union pension funds have forced companies to be held to account for their social, corporate governance and environmental performance and impact and restrained CEOs' and directors' remuneration. This kind of activism is deep rooted in a broader understanding of the role and responsibility of corporations in promoting sustainable development. It recognises that shareholder reward is dependent on the long-term success of the company and, for foreign investors, that national diversity of corporate governance systems must be respected. By contrast, shareholder activism that is short-termist and that seeks to extract maximum value from the company in the short term to the detriment of the companies' long-term interest is extremely worrying. Unscrupulous shareholder activists that obtain mega dividends and massive share buy-back programmes the value of which may be superior to the company's R&D budget – must be denounced.

[iv] See http://www.workerscapital.org

The CWC has engaged in active dialogue with union-sponsored pension fund trustees on the risks and opportunities of investments in private equity. In July 2007, the ITUC General Council agreed on a resolution calling upon 'trustees and fiduciaries of pension funds to consider investments in private equity and hedge funds with extreme caution' (ITUC 2007). The LBO financing model has strong similarities with the credit derivative markets. Like the subprime market, it is widely assumed that investors and creditors that invest in LBO transactions do not understand what they are buying, cannot measure appropriately their risk exposure and, accordingly, are adopting excessive risk appetite behaviour. The role of pension funds is particularly crucial in this regard, given the size of their investments in private equity funds. Pension funds must be given the tools, which are currently missing because of lack of regulation, to ensure effective risk management of their investment in alternative funds. In turn, this would require reviewing transparency and governance regulatory requirements of private equity firms and funds. The restrictive governance of limited partnerships under which private equity funds are ruled gives a limited role to limited partners in the decision-making process. Some observers have also pointed to the inconsistency of the investment policies of institutional investors in respectively listed and private equity companies. While investors can have active shareholder policies in the AGM of listed companies and insist on key governance standards such as disclosure, in the words of Paul Myners 'investors can be quite lethargic' when investing in private equity funds.

The way ahead

In developing responses to the financialisation of the economy, unions at the international level are reinforcing their cooperation and complementing traditional tools such as collective bargaining with new tools that recognise that trade unions and workers are both one side of the equation. The TUAC will continue to work on issues related to the financialisation of the economy and its recent manifestations in the form of alternative investment funds such as private equity. The TUAC will do so in close partnership with key sister organisations at the international level, including the ETUC, the ITUC and Global Union Federations. On that, we particularly welcome a recent Resolution by the ETUC Council calling, inter alia, for 'strengthening cooperation with ITUC, TUAC, EIF on bringing alternative investment funds under better control (concentrating on regulation, information, consultation, negotiation, taxation)' (ETUC 2007). What is at stake is to bring financial market regulation into line with the needs of the real economy and workers.

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